

Internal Revenue Service  
**memorandum**

CC:TL:Br2  
MSRichmond

date: MAR 24 1987

to: District Counsel, New Orleans CC:NO  
Attn: LBourquin

from: Director, Tax Litigation CC:TL

subject: [REDACTED]

This is pursuant to your request of <sup>MARCH 17,</sup> ~~May 6,~~ 1987, for technical advice in the above case. You requested advice on whether for purposes of calculating the accumulated earning tax, any increases in petitioner's tax liability resulting from the litigation in the Tax Court should be allowed as reduction in taxable income for Federal income taxes paid or accrued during the taxable years litigated.

Petitioner petitioned the Tax Court for a redetermination of its Federal income tax liability for taxable years [REDACTED] through [REDACTED]. The compensation claimed by the petitioner as a deduction on its returns for those years were determined by the Service to be unreasonable. Likewise, the accumulated earnings and profits of the petitioner for taxable years [REDACTED] and [REDACTED] were also determined to be unreasonable and, therefore, resulted in imposition of the accumulated earnings tax. The Tax Court held that for taxable years [REDACTED] through [REDACTED], the petitioner claimed unreasonable compensation. Moreover, the Court found that for taxable years [REDACTED] and [REDACTED], the petitioner unreasonably accumulated its earnings and profits and that the petitioner was liable for the accumulated earnings tax. [REDACTED], revised by order of Court in [REDACTED]. Consistent with the Court's holding, you have prepared the required rule 155 computation for entry of decision, but petitioner has refused to execute the document because the computation does not provide for reductions in taxable income for the deficiencies resulting from this litigation. Therefore, you also requested whether you should proceed as you normally would and file the 155 document unagreed.

Section 531 imposes an accumulated earnings tax on corporations subject to the accumulated earning tax as set forth in section 532 found to have unreasonably accumulated its earnings and profits. Section 535(b)(1) provides that Federal income taxes paid or accrued during the taxable year shall be allowed as a deduction from taxable income in computing accumulated taxable income.


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Treas. Reg. §1.535-2(a)(1) provides that in computing the amount of taxes accrued, an unpaid tax that is being contested is not considered accrued until the contest is resolved. The Tax Court in Doug-Long, Inc. v. Commissioner, 73 T.C. 71 (1979), upheld Treas. Reg. §1.535-2(a)(1). It also concluded that a protested income tax deficiency is a contested tax and that a contested tax is not subtracted from taxable income in the calculation of accumulated taxable income. Rev. Rul. 68-632, 1962-2 C.B. 253, provides that Federal income taxes paid or accrued may include an increase in tax liability resulting from uncontested adjustments. Rev. Rul. 68-632 further provides that the term contest means affirmative evidence of denial of liability by the taxpayer and includes a contest lodged with the Service as well as a contest in a court.

Applying the above authorities to the petitioner, we recommend that you file the unagreed 155 document with the Court. Petitioner did not agree to the proposed adjustments to taxable income but rather contested the adjustments in the Tax Court. <sup>1/</sup> While it is true that Federal income taxes paid or accrued may include an increase in tax liability resulting from uncontested adjustments, it is also true that unpaid and contested tax liability is not considered accrued until the contest is resolved. Thus, the increase in petitioner's Federal tax liability resulting from the litigation does not accrue until the contest is resolved. Therefore, petitioner may not reduce its taxable income for the taxable years litigated by the amount of the contested deficiencies.

ROBERT P. RUWE

By:

  
ALFRED C. BISHOP, JR.  
Chief, Branch 2  
Tax Litigation Division

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<sup>1/</sup> While the matter was pending before the Tax Court, petitioner sought certiorari from an interlocutory ruling on the burden of proof under I.R.C. §534. 